> looking economic cost principles would promote competition in rural study areas by providing more accurate investment signals to potential competitors 32/

The Commission reaffirmed its long-term commitment to the use of forward-looking costs to set universal service support levels in its recent *RTF Order* The Commission specifically stated that it "disagree[d]" with rural ILEC representatives who argued "that the forward-looking cost mechanism should not be used to determine rural company support and that only an embedded cost mechanism will provide sufficient support for rural carriers." 33/ Rather, the Commission reaffirmed its previous conclusions regarding the transition from a universal service system based on rate-of-return to one based on forward-looking costs

> The Commission previously determined that support based on forward-looking cost is sufficient for the provision of the supported services and sends the correct signals for entry, investment, and innovation . . While the Rural Task Force demonstrated the inappropriateness of using input values designed for non-rural carriers to determine support for rural carriers, we do not find that its analysis justifies a reversal of the Commission's position with respect to the use of forward-looking cost as a general matter. 34/

The Commission indicated that it would soon initiate a "comprehensive review of the high-cost mechanisms for rural and non-rural carriers as a whole," in which it

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32/ *Id* at 8935, ¶ 293 The Commission, however, declined to move rural ILECs immediately into a forward-looking cost-based system immediately due to concerns about the applicability of the cost models to rural ILECs *Id* at 8935-37, ¶¶ 294-95

33/ *RTF Order*, 16 FCC Rcd at 11311, ¶ 174 (2001) (emphasis added)(citations omitted)

34/ *Id* *Accord, Texas Office of Public Utility Counsel v FCC*, 183 F 3d 393, 412 (5th Cir 1999) (affirming that forward-looking support satisfies statutory "sufficiency" criterion), *Alenco*, 201 F 3d at 620 (same)

would "consider all options, including the use of forward-looking costs, to determine appropriate support levels for both rural and non-rural carriers." 35/

It is time for the Commission to deliver on these commitments. The Commission should promptly open the rulemaking Western Wireless proposes, and should work toward eliminating ROR regulation and replacing it with a system based on forward-looking costs

III. THE FAILED SYSTEM OF RATE-OF-RETURN REGULATION MUST BE ELIMINATED AND REPLACED EXPEDITIOUSLY

In adopting the 1996 Act, Congress challenged regulators to adopt a new regulatory paradigm that would be consistent with the emergence of competition throughout the telecommunications industry, including in rural and high-cost areas, while also preserving and advancing the goal of universal service Up to now, the Commission has delayed the inevitable changes to the ROR system of regulating RLECs, perhaps due to concerns about the impact of this competitive transformation on rural carriers and their customers and the need for a gradual transition However, the time has come to begin making the changes necessary to focus universal service policy on "sufficient funding of *customers*, not *providers*." 36/

As discussed below, the existing ROR system is pernicious for three reasons (1) it precludes the development of competition on a level playing field, and thereby harms consumers in rural areas who are deprived of the benefits of

35/ *RTF Order* 16 FCC Rcd at 11310, ¶¶ 169-70

36/ *Alenco*, 201 F 3d at 620 (emphasis in original)

such competition, (2) it gives carriers incentives to operate inefficiently and discourages them from introducing technological innovations, to the detriment of rural consumers, and (3) it creates opportunities for waste, fraud and abuse and causes the *unwarranted* expansion of the universal service fund, harming consumers nationwide who ultimately pay into the fund

A. ROR Regulation Artificially Interferes With Competition

ROR regulation harms consumers in rural areas by artificially interfering with competition Competition in the universal service market benefits consumers by "increasing customer choice, innovative services, and new technologies," by promoting "the deployment of new facilities and technologies" while providing "an incentive to the incumbent rural telephone companies to improve their existing network to remain competitive," and by "creating incentives to ensure that quality services are available at 'just, reasonable, and affordable rates' " 37/ But such competition on a level playing field is impossible under the current ROR rules.

First, the current funding mechanism asymmetrically provides full historical cost recovery for incumbents, but per-line recovery for new entrants. It thereby creates a bias in favor of the incumbent This can distort competitive outcomes and reduces economic efficiency There can be no level competitive playing field when the incumbent not only enjoys the natural advantages of

37/ *Federal-State Joint Board on Universal Service, Western Wireless Corp Petition for Designation as an Eligible Telecommunications Carrier in the State of Wyoming*, 16 FCC Rcd 48, 56 ¶ 17 (Com Car Bur 2000), *aff'd* 16 FCC Rcd 19144 (2001)

incumbency, but also enjoys a government-guaranteed return on investment, while competitive ETCs' investments are completely at risk. ROR regulation provides revenue guarantees for ILECs, but not competitive ETCs, which is fundamentally antagonistic to competition. 38/

Second, ROR concepts drive a fundamentally unbalanced high-cost regime for rural ILECs and competitive ETCs. Rural ILECs are assured a particular level of support even if they lose access lines and market share to a competitor. The Commission originally adopted a rule that would have taken support away from ILECs as competitive ETCs gain market share, but abandoned this competitive market-based rule for a return to ROR regulation. 39/ Competitive ETCs receive support only for the customer connections they serve – that is, they receive support only to the extent they garner market share, and if they lose customers, they lose support. Competition on a level playing field is impossible when one class of competitors receives such unbalanced regulatory advantages. 40/

Third, ROR-based access charges and universal service support create inaccurate and inefficient incentives for competitive entrants, as well as for incumbent carriers. The Commission's recent condemnation of the use of historical

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38/ Rather than creating revenue guarantees for competitive ETCs as well, as some parties suggest, the Commission should eliminate such guarantees for all carriers.

39/ *Federal-State Joint Board on Universal Service*, Ninth Report and Order, 14 FCC Rcd 20432 (1999), *rev'd in part on other grounds sub nom. Qwest Corp. v. FCC*, 258 F.3d 1191 (10th Cir. 2001). *See also* Rural Task Force, *RTF White Paper #5: Competition and Universal Service* at 16 (Sept. 2000) (available at http://www.wutc.wa.gov/rtf).

40/ *See Western Wireless Corp. Petition for Preemption of Statutes and Rules Regarding the Kansas State Universal Service Fund Pursuant to Section 253 of the Communications Act of 1934*, 15 FCC Rcd 16227, 16231, ¶ 10 (2000).

costs in UNE rate setting applies with equal force to the use of historical costs in setting rural ILECs' access charge rates and universal service support levels:

> In addition to the problems associated with reliance on incumbent LEC accounting records, the use of historical costs does not necessarily provide efficient investment signals to potential entrants. As many economists have noted, it is forward-looking costs, not historical costs, that are relevant in setting prices in competitive markets. If historical costs are higher than the forward-looking costs an entrant would face, setting rates on the basis of historical cost could result in UNE prices that deter entry generally, or cause entrants to build their own facilities even when it is inefficient to do so. Conversely, if historical costs are lower than forward-looking costs, UNE rates based on historical costs might cause entrants to lease facilities when it was more efficient either to build their own or not to enter a particular market. 41/

B. ROR Regulation Creates Incentives for Inefficiency and Impedes Innovation

ROR regulation creates incentives for ILECs to operate inefficiently (even in a monopoly environment), because it entitles them to cost recovery regardless of how inefficient the investment. The Commission recognized this problem over ten years ago:

> First, as a profit-maximizer, the firm is led to adopt the most costly, rather than the most efficient, investment strategies because its primary means of increasing dollar earnings under rate-of-return constraints is to enlarge its rate base. * * * Second, since all operating expenses are included in a firm's revenue requirement under rate of return, management has little incentive to minimize operating costs. * * * In both cases, consumers suffer because these distorted incentives increase the cost of doing business – and thus the rates consumers must pay for service. * * * * *
>
> The distorted efficiency incentives established by rate-of-return regulation also may have a negative effect on innovation. Clearly, rate-of-return establishes no incentive to 'do the same old thing a better

41/ *TELRIC NPRM* at ¶ 32

> way' – for example, by providing the same service at lower cost – because a carrier's reward for such innovation is a reduction in its dollar earnings Such regulation may well have similar effects on incentives to produce new products and services. 42/

The Commission expanded on this analysis in its 1989 order eliminating ROR regulation for AT&T and proposing to eliminate it for the large ILECs, concluding as follows.

> Under rate of return, however, "normal" profit levels are established in advance by regulatory fiat The dynamic process that produces socially beneficial results in a competitive environment is strongly suppressed In fact, rather than encourage socially beneficial behavior by the regulated firm, rate of return actually discourages it.
>
> The distorted incentives created by rate of return regulation are easily illustrated. In a competitive environment, where prices are dictated by the market, a company's unit costs and profits generally are related inversely If one goes up, the other goes down. Rate of return regulation stands this relationship on its head. Although carriers subject to such regulation are limited to earning a particular percentage return on investment during a fixed period, a carrier seeking to increase its dollar earnings often can do so merely by increasing its aggregate investment. In other words, under a rate of return regime, profits (*i e* , dollar earnings) can go up when investment goes up. This creates a powerful incentive for carriers to "pad" their costs, regardless of whether additional investment is necessary or efficient. And, because a carrier's operating expenses generally are recovered from ratepayers on a dollar-for-dollar basis, and do not affect shareholder profits, management has little incentive to conserve on such expenses. This creates an additional incentive to operate inefficiently Moreover, in situations in which carriers providing more than one service face competition for one or more of such services, rate of return regulation enables carriers to distort the competitive process by manipulating their reported cost allocations.
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> A system that establishes such incentives is unlikely to encourage efficiency Moreover, administering rate of return regulation in order

42/ *Price Cap FNPRM*, 3 FCC Rcd at 3219-20, 3223, ¶¶ 39, 46, *see also* Harvey Averch and Leland L Johnson, "Behavior of the Firm under Regulatory Constraint," 52 Amer Econ Rev 1052 (1962, Alfred E Kahn, *The Economics of Regulation Principles and Institutions*, vol 2, at 17-59 (1971)

> to counteract these incentives is a difficult and complex process, even when done correctly and well. This is so primarily [because] . . . . a regulator may have difficulty obtaining accurate cost information as the carrier itself is the source of nearly all information about its costs. Furthermore, no regulator has the resources to review in detail the thousands of individual business judgments a carrier makes 43/

The Commission went on to observe the difficulty of preventing cost misallocations and cross-subsidies, particularly in an environment of technological advancement, increasing competition, and "a continuing shift in the boundaries between the competitive and less competitive segments of the telecommunications marketplace" 44/

Thus, rate of return regulation is widely recognized as eliminating incentives for carriers to operate efficiently, improve productivity, or introduce innovative technologies and services 45/ As the U S Court of Appeals for the D.C. Circuit explained in upholding the shift from ROR to price caps for larger ILECs, "because a firm can pass any cost along to ratepayers (unless it is identified as imprudent), its incentive to innovate is less sharp than if it were unregulated." 46/ This conclusion is supported by empirical econometric research, which confirms that

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43/ *AT&T Price Cap Order*, 4 FCC Rcd at 2889-90, ¶¶ 29-31 (emphasis in original).

44/ *Id* 4 FCC Rcd at 2890-91, ¶ 34

45/ *Price Cap Performance Review for Local Exchange Carriers*, 10 FCC Rcd 8961, 8973, ¶ 27 (1995), subsequent history omitted, *ILEC Price Cap Order*, 5 FCC Rcd at 6789-90, ¶¶ 22, 29-32

46/ *National Rural Telecom Ass'n v FCC*, 988 F 2d 174, 178 (D C Cir 1993)

"using rate-of-return regulation does have the unintended consequence of decreasing the firm's expenditures on R&D." 47/

In the *Universal Service First Report and Order*, the Commission specifically recognized the inefficiency of the current embedded-cost support mechanisms in the context of rural ILECs operating under ROR regulation:

> We find that the current support mechanisms neither ensure that ILECs are operating efficiently nor encourage them to do so. Indeed, by guaranteeing carriers recovery of 100 percent of all loop costs in excess of 150 percent of the national average loop cost, the current high-cost funding mechanisms effectively discourage efficiency. Thus, we agree with [Citizens for a Sound Economy] that calculating high-cost support based on embedded cost is contrary to sound economic policy. We conclude that basing support on forward-looking economic cost or perhaps competitive bidding will require telecommunications to operate efficiently and will facilitate the move to competition in all telecommunications markets. 48/

In addition, the current unjustifiable disparity between the regulatory systems for areas served by so-called "non-rural" ILECs and areas served by rural ILECs creates very strong, uneconomic incentives for large ILECs to sell exchanges to small ones, even though there are economies of scale that can be achieved by the larger carriers. 49/ While sparsely populated rural *areas* undoubtedly are more

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47/ *See, e.g.*, Mark W. Frank, *The Impact of Rate-of-Return Regulation on Technological Innovation* at 124 (Ashgate Publishing Ltd, Aldershot, England and Burlington, VT 2001).

48/ *Universal Service First Report and Order*, 12 FCC Rcd at 8934-35, ¶ 292. The Commission, however, declined to move rural ILECs into a forward-looking cost-based system immediately due to concerns about the applicability of the cost models to rural ILECs. *Id.* at 8935-37, ¶¶ 293-95.

49/ *See RTF Order*, 16 FCC Rcd at 11310, ¶ 169, *see also* Western Wireless Opposition to Valor Telecommunications of Texas, L.P. Petition for Waiver of Section 54.305, CC Docket No. 96-45 (filed May 30, 2003), at 2-3. There are dozens – possibly hundreds – of cases in which small ILECs have purchased exchanges from larger ILECs and realized economic gains from increased universal service support, with the FCC's sanction. *See, e.g., Nemont Telephone*

costly to serve, there is nothing unique about the rural *ILECs*, and no economically principled reason to provide differing amounts of high-cost support to small ILECs, large ILECs, or competitive ETCs, if the carriers serve similar or identical geographic areas. 50/

C. Embedded Cost-Based Universal Service Support Generates Excessive Funding And Is Highly Susceptible to Fraud, Waste, and Abuse.

Embedded-cost-based support in a system of ROR regulation is arbitrary and not properly reflective of true costs First, as a theoretical matter, embedded costs are economically irrelevant to economic decision-making, and therefore the use of embedded costs in setting rates and high-cost support is inaccurate There is a consensus among economists that "it is forward-looking costs, not historical costs, that are relevant in setting prices in competitive markets." 51/ Forward-looking costs – *not* sunk costs – represent the costs that, in the real world, drive the economic decision-making of both incumbent providers and prospective

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Cooperative, Inc , et al , Joint Petition for Waiver of the Definition of "Study Area," 18 FCC Rcd 838, 842-43, ¶ 11 (Wireline Comp Bur 2003) (noting that the acquiring companies expect to receive additional interstate common line support as a result of the transfer), *Citizens Utilities Rural Co , Inc and Qwest Corp , Joint Petition for Waiver of the Definition of "Study Area," Order*, 16 FCC Rcd 13032, 13036, ¶ 10 (Com Car Bur 2001) (permitting Qwest to transfer 38 telephone exchanges to Citizens and noting that "the transferred exchanges may receive increased interstate access universal service support as a result") *See also* 47 C F R § 54 902

50/ While there *are* differences between rural areas and other geographic areas – it costs more to serve areas where the population is sparse, whether using wireline or wireless technology, regulation should be neutral on the issue of carrier identity and size, and certainly should not reward a carrier just for being small or for being an incumbent

51/ *TELRIC NPRM* at ¶ 32

new entrants regarding investment, production, and pricing 52/ Thus, a truly "cost-based" system would utilize forward-looking costs, not embedded (or backward-looking) costs

Second, even if embedded cost-based regulation were appropriate as a theoretical matter, in practice the existing ROR regulatory system is fatally flawed by generations of regulatory distortions ROR regulation is driven by FCC rules (principally Parts 32, 36, and 69) that were designed for the primary purpose of generating cross-subsidies and/or shifting revenues between the state and federal jurisdictions 53/ There is no reason to think that the revenues driven by these existing rules have any relationship to the "reality" even as generated by accounting costs

Third, and perhaps most significantly, the ROR regulatory system is likely to be highly inaccurate because it depends heavily on the ILECs' self-reporting based on their own accounting records, which have never been audited or scrutinized by independent auditors or regulators. As the Commission recently pointed out,

> Traditional rate-base/rate-of-return ratemaking has generally been based on the use of historical costs, *i.e.*, the costs the regulated firm incurred in building its network and providing service and that it

52/ *Id* at ¶ 30 *See also Local Competition Order*, 11 FCC Rcd at 15813, ¶ 620, Walter Nicholson, *Microeconomic Theory Basic Principles and Extensions*, pages 279-82 (3rd ed , 1984) (explaining difference between economists' focus on forward-looking costs and accounting focus on sunk costs). Thomas T Nagle, *The Strategy & Tactics of Pricing: A Guide to Profitable Decision Making*, 14-28 (1987) (at page 15 "Only forward-looking costs are relevant for pricing because only they represent the true cost of doing business ")

53/ *See* Peter W Huber, Michael K Kellogg, and John Thorne, *Federal Telecommunications Law* at 551-560 (2d ed 1999)

> recorded in its books of account. As an initial matter, an historical cost approach is highly dependent on the accuracy of an incumbent LEC's accounting records, which potentially creates a significant information asymmetry that benefits the incumbent LECs. 54/

But no comprehensive audit of the regulatory accounts of the vast majority of rural ILECs has been conducted in the past decade, either by the FCC, state commissions, NECA, 55/ the Universal Service Administrative Co ("USAC"), or independent auditors retained by the ILECs themselves Thus, there is no reason to presume the accuracy of the regulatory books of account (kept separately from the books of account maintained and audited for tax purposes)

Indeed, there is good reason to think that the rural ILECs' costs may be significantly overstated, which would result in a bloated high-cost fund The existing regulatory system provides ample opportunities and incentives for ROR-regulated ILECs to misreport costs in a manner that would improperly augment universal service disbursements and "pad their rates," 56/, such as by improperly allocating costs to ILEC regulated operations that more properly should have been allocated to other activities As demonstrated in Attachment A to this Petition, certain state commissions have unearthed extensive incidents of cross-subsidization and other improper accounting practices

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54/ *TELRIC NPRM* at ¶ 32

55/ While NECA does review ROR carriers' cost study and high-cost fund submissions, the scope and outcomes of these reviews are not made public. Moreover, NECA does not have sufficient staff to conduct stringent reviews or audits of all carriers' cost data, and given that NECA (through its Board of Directors) is run by and for the ILECs themselves, NECA is not sufficiently independent of rate of return ILEC interests to support a strong oversight function

56/ *Price Cap FNPRM*, 3 FCC Rcd at 3219-20, ¶ 39

- The California Public Utilities Commission found that a mid-sized company had (i) improperly misallocated corporate/managerial costs, regulatory costs, land and building costs, and other expenses to the ILEC that should have been allocated to the company's cable television, wireless, long-distance, and alarm monitoring affiliates, in violation of the FCC's Part 64 rules, (ii) expensed software development costs in a single year, contrary to Generally Accepted Accounting Principles, and (iii) improperly booked the costs of institutional and goodwill advertising in the ILEC's regulated accounts.

- The Idaho Public Utilities Commission reduced an ILEC's claim to recover the cost of payments to affiliates and certain software capital leases, since those expenditures were related to the provision of unregulated services. The Idaho commission also rejected recovery of the costs of equipment that was no longer in service and costs of fiber that had not yet been placed into service, and it disallowed recovery of corporate image advertising costs and a depreciation reserve deficiency.

- The Kansas Corporation Commission reached a settlement with two RLEC subsidiaries of one holding company that precluded them from receiving any state universal service support, based on a finding that the holding company had improperly allocated the entire cost of management stock incentives and financial advisory fees paid to the owners of the holding company to the regulated ILEC, and had allocated no corporate costs to unregulated subsidiaries.

- The Kansas commission found that another ILEC had claimed depreciation expenses on plant that had already been fully depreciated, misallocated deferred income taxes relating to non-regulated affiliates, and improperly booked consulting fees that had no relationship with regulated operations

- The Kansas commission found that a carrier had claimed more property tax expense than it had actually paid during the test year, utilized depreciation rates in excess of those permitted by the commission, and improperly included lobbying and corporate image advertising expenses.

- The Oregon commission disallowed an ILEC's claim to depreciation recovery for equipment that had already been retired, rejected recovery of executive bonuses paid for achieving corporate financial goals that benefited shareholders rather than ratepayers, and made adjustments for the company's failure to reflect the reduction in expenses realized through the sale of several exchanges.

- The Vermont commission rejected an ILEC's attempt to recover the non-recurring costs of operational support systems ("OSS"), which had already been recovered through interconnection rates, and of local number portability implementation, for which the FCC had already developed an interstate cost recovery mechanism.

- The Washington commission disallowed an ILEC's recovery of corporate image advertising costs, rejected its attempt to use depreciation rates that the commission had already rejected, and disallowed the costs of purchases from an affiliate at prices that exceeded market prices.

Other examples are discussed in Attachments A and B.

Given the very strong perverse incentives and the lack of effective auditing or oversight of their ROR accounting, undoubtedly a far greater number of incidents are never detected, resulting in excess support flowing to the ILECs. The Commission cannot ignore the ROR ILECs' interstate overearnings (*i.e.*, revenues from interstate access charges plus universal service fund disbursements that exceed the 11.25% allowed rate-of-return) of over $218 million in the 2001-2002 period, $92 million in 1999-2000 and $121 million in 1997-1998 57/

Moreover, even if and when the Commission does detect ROR carriers' over-earnings, the Commission may not be able to remedy them In a recent case, the Commission found that an ILEC had earned excessive amounts by improperly allocating certain costs to the interstate jurisdiction that applicable rules required to be treated as intrastate The reviewing court upheld the Commission's

57/ *See* AT&T Ex Parte Filing, CC Docket Nos 00-256, 96-45, 98-77, and 98-166 (filed May 9, 2003) (demonstrating that numerous rate-of-return ILECs are earning in excess of the 11 25% authorized rate of return)

conclusion that the ILEC had misallocated these costs. 58/ Nonetheless, the court held that, because the Commission had not suspended the tariff rates and established an investigation at the time the relevant tariff was filed, the rates were conclusively "deemed lawful" under 47 U.S.C. § 204(a)(3), and therefore the Commission was without authority to order rate refunds or damages. 59/ Thus, even with respect to those incidents of ROR malfeasance that the Commission detects (most likely a small minority), in most cases the Commission may lack authority to order an effective remedy. In effect, this could well mean that ROR regulation is unenforceable in the context of tariffed interstate access charges. An alternative regulatory framework is urgently needed.

"In an era of corporate governance problems and accounting depredations, this Commission has an especially high burden" of responsibility to establish and enforce accounting safeguards "that help prevent and detect anticompetitive behavior" by rural ILECs. 60/ The most effective way to preclude such waste, fraud, and abuse would be to eliminate the ROR regulatory system, which provides the opportunity and incentives for such misconduct. However, during the time period when ROR regulation remains in effect, we propose a

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58/ *ACS of Anchorage, Inc. v. FCC*, 290 F.3d 403 (D.C. Cir. 2002), *affirming in part and reversing and remanding in part General Communication, Inc. v. Alaska Communications Systems Holdings, Inc.*, 16 FCC Rcd 2834 (2001).

59/ *Id.*

60/ Separate Joint Statement of Commissioner Michael J. Copps and Commissioner Jonathan S. Adelstein, Concurring, *Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements*, WC Docket No. 02-112, Further Notice of Proposed Rulemaking, FCC 03-111 (released May 19, 2003).

number of interim steps that the Commission should take to oversee the ROR regulatory process more stringently, enhance the transparency of the process, and limit the potential for abuse. Specifically, the FCC should make the following changes immediately

- Carriers' cost studies, work papers, and other data submissions supporting their high-cost funding should be made publicly available, given that high-cost support is a form of public funding.
- As with the 1999 audits of the Bell companies' Continuing Property Records, 61/ the results of any reviews of cost studies or other data submissions involving high-cost funding conducted by the NECA or USAC over the past three years should be made publicly available
- Truly independent auditors (*i.e.*, public accounting firms) should be retained under the supervision of the Commission and/or USAC to conduct audits of the data underlying the high-cost submissions of ROR ILECs no less frequently than every three years, and more frequently if there is a significant increase in a company's year over year funding requests. Companies should be required to provide full access to their books and records, and the results of the audits would be made publicly available
- Among other matters, audits should focus on whether the subject ILEC is properly classifying its loops and other facilities in reporting loop counts and network investments, whether the carrier has proper cost accounting manuals, with adequate internal controls in place; whether the carrier complies with affiliate transactions rules; and whether costs are booked to the correct Part 32 accounts, and other factors such as interest expense on debt and interest during construction, and cash working capital are recorded and accounted for correctly 62/

61/ *Ameritech Corporation Tel Op Cos Continuing Property Records Audit*, 14 FCC Rcd 1273 (1999), *BellSouth Tel Continuing Property Records Audit*, 14 FCC Rcd 4258 (1999), *Bell Atlantic (South) Tel Cos Continuing Property Records Audit*, 14 FCC Rcd 5541 (1999), *Bell Atlantic (North) Tel Cos Continuing Property Records Audit*, Order, ASD File No 99-22 (Mar 12, 1999) *Pacific Bell and Nevada Bell Tel Cos Continuing Property Records Audit* 14 FCC Rcd 5839 (1999), *U S West Tel Op Cos Continuing Property Record Audits*, Order, ASD File No 99-22 (Mar 12, 1999), *Southwestern Bell Tel Co Continuing Property Records Audit*, 14 FCC Rcd 1242 (1999) (collectively, "*RBOC Audit Orders*") (subsequent history omitted)

62/ *See* Attachment B, at 10-11

- The Commission should immediately suspend and investigate *all* tariff filings of ROR carriers in order to avoid the statutory "conclusive presumption" that the rates are "deemed lawful," and thereby preserve the Commission's ability to order refunds or damages in the event that over-earnings are later detected

* * * * *

In sum, the current system of embedded cost-based support for rural ILECs and ROR regulation artificially inhibits the development of competition, encourages inefficiencies, and creates opportunities for ILECs to improperly expand the size of their funds through fraud, waste, and abuse. Rather than making regulatory changes that would impose further artificial constraints on competition, such as eliminating portability, it is time to eliminate embedded cost-based support and ROR regulation

IV. THE COMMISSION SHOULD ESTABLISH A COMPETITIVELY NEUTRAL, PORTABLE HIGH-COST FUNDING SYSTEM BASED ON FORWARD-LOOKING COSTS

The Commission should open a proceeding to develop a more appropriate high-cost funding system based on forward-looking costs to determine identical support amounts for all ETCs serving a particular geographic area. As the Commission recently explained

> A forward-looking costing methodology considers what it would cost today to build and operate an efficient network (or to expand an existing network) that can provide the same services as the incumbent's existing network. The benefit of a forward-looking approach is that it gives potential competitors efficient price signals in deciding whether to invest in their own facilities or to lease the incumbent's facilities That is, if construction of new facilities by a competitive LEC would cost less than leasing facilities at prices based

> on [forward-looking economic cost], the efficient result is for the new entrant to build its own facilities 63/

Forward-looking costs - determined using an economic model or other forward-looking methodology, rather than by reference to an individual carrier's accounting records - more accurately gauges the costs driving economic decision-making by any enterprise Forward-looking costs can also be neutral as between incumbents and new entrants, and between wireless and wireline technologies:

> [W]e find that the use of mechanisms incorporating forward-looking economic cost principles would promote competition in rural study areas by providing more accurate investment signals to potential competitors. * * * Because support will be calculated and then distributed in predictable and consistent amounts, such a forward-looking economic cost methodology would compel carriers to be more disciplined in planning their investment decisions.. 64/

A. The Commission Should Develop Appropriate Forward-Looking Costing Analytical Platforms and Inputs

The first step in developing a new forward-looking cost-based system for computing high-cost support is developing an analytical platform and appropriate inputs with respect to the forward-looking cost – "what it would cost today to build and operate an efficient network (or to expand an existing network) that can provide the same services as the incumbent's existing network" 65/ – in areas served by rural ILECs and their competitors The Commission should seek comment on issues such as the following.

63/ *TELRIC NPRM* at ¶ 30

64/ *Universal Service First Report and Order*, 12 FCC Rcd at 8935-36, ¶ 293

65/ *TELRIC NPRM* at ¶ 30

- Whether the existing Synthesis Model provides an adequate model platform for this purpose;

- If so, what modifications to input assumptions (if any) would be needed to apply that model to areas served by rural ILECs and their competitors,

- If the Synthesis Model cannot be used or adapted, how an alternative model platform or other forward-looking cost methodology should be developed 66/

Although, the Rural Task Force expressed reservations about utilizing the existing Synthesis Model to develop support amounts for rural carriers, 67/ the Commission correctly recognized that:

> Many commenters representing the interests of rural telephone companies argue that the Rural Task Force's analysis conclusively demonstrates that the forward-looking cost mechanism should not be used to determine rural company support and that only an embedded cost mechanism will provide sufficient support for rural carriers. *We disagree*. While the Rural Task Force demonstrated the inappropriateness of using input values designed for non-rural carriers to determine support for rural carriers, we do not find that its analysis justifies a reversal of the Commission's position with respect to the use of forward-looking cost as a general matter. 68/

It is also significant that the recent *TELRIC NPRM* seeks comment on forward-looking costing matters with respect to UNEs offered by small ILECs as well as larger carriers. 69/ While UNE pricing entails some different methodological issues

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66/ Western Wireless has demonstrated that it is quite possible to develop an appropriate model to implement a forward-looking cost methodology for rural ILECs *See* James W Stegeman, "Proposal for a Competitive and Efficient Universal Service High-cost Funding Model/Platform," Attachment I to Western Wireless *Comments in Joint Board Competitive ETC Proceeding*

67/ *Rural Task Force Recommendation to the Federal-State Joint Board on Universal Service*, 16 FCC Rcd 6165, 6181 (2000)

68/ *RTF Order*, 16 FCC Rcd at 11311-12, ¶¶ 174-75 (emphasis added)(citations omitted)

69/ *TELRIC NPRM* at ¶¶ 161, 163

than determination of forward-looking costs for universal service high-cost support purposes, there are many related issues, and the Commission can productively address both the UNE pricing and high-cost support issues simultaneously, and can do so using many (if not all) of the same criteria. For example, for purposes of developing appropriate forward-looking inputs to the rural universal service cost methodology, the Commission should consider how to develop dynamically efficient, forward-looking demand estimates that account for the development of facilities-based competition (*i e* , that no single provider's facilities will serve 100% of the consumer demand in any given area) 70/

The Commission's costing analysis efforts in the context of universal service should not be limited to ILEC network costs In many cases, wireless networks may incur lower forward-looking costs to provide basic universal service 71/ For example, in 1998 Western Wireless developed a Wireless Cost Model based largely on the HAI wireline model, but incorporating a wireless network module in place of the HAI model's standard wireline loop module. The Hatfield Wireless Model ("HWM") estimates the cost of wireless service, using cluster population data and ILEC traffic loads to determine cell site, equipment,

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70/ *Cf TELRIC NPRM* at ¶ 75

71/ For this purpose, both ILEC and CMRS cost models should estimate the cost of providing the supported services included in the "definition of universal service " *See Federal-State Joint Board on Universal Service*, Order and Order on Reconsideration, 18 FCC Rcd 15090 (2003) (reaffirming existing definition of "universal service")

and backhaul requirements, and using the transport, switching, signalling and other cost data from the HAI wireline model 72/

The goal of universal service must be to preserve and advance universal service as efficiently as possible, and therefore the forward-looking approach for purposes of determining high-cost support amounts should be calculated, for *all* carriers, based on the *lesser* of the forward-looking cost of ILEC network technology or the forward-looking cost of wireless network technology. The Commission recently reaffirmed its "commitment to forward-looking costing principles," and explained that "[a] forward-looking costing methodology considers what it would cost today to build and operate an efficient network (or to expand an existing network) that can provide the same services as the incumbent's existing network 73/ Consistent with the Commission's theory of forward-looking cost, the Commission should make funding available based on the *lower* of the efficient forward-looking costs of ILEC real-world networks and the efficient forward-looking costs of real-world wireless networks, developed based on "the real-world attributes of the routing and topography" of such carriers' networks 74/ For example, Western Wireless demonstrated that, if universal service support were based on the lesser of ILEC forward-looking costs or wireless forward-looking costs, then there

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72/ *See Ex Parte* Letter from David L Sieradzki, Counsel for Western Wireless Corp , to Magalie Roman Salas, FCC Secretary, CC Docket No 96-45 (Aug 26, 1998) (available at http://gullfoss2.fcc.gov/prod/ecfs/retrieve.cgi?native_or_pdf=pdf&id_document=2140160001 and http://gullfoss2.fcc.gov/prod/ecfs/retrieve.cgi?native_or_pdf=pdf&id_document=2140160002) ("*Western Wireless Model Ex Parte*")

73/ *TELRIC NPRM*, ¶¶ 29, 30

74/ *Id* at ¶ 52

could be a savings of 48% compared to providing universal service support based only on wireline technology 75/

As part of the process of re-examining the forward-looking cost analytical process, the Commission should reconsider some of the ILEC-centered assumptions it has made in its past modeling efforts For example, in the original Synthesis Model for high-cost universal service support, the Commission began with an assumption that the basic geographic unit of analysis was the ILEC wire center The Commission should consider dropping that assumption and, instead, use a technology-neutral geographic unit of analysis, such as counties or census-block-groups One advantage of such an approach is that data on the specific geographic boundaries and other features of such units are more readily available to the public than ILEC wire center and study area boundaries.

B. The Commission Should Establish a Competitively Neutral Methodology to Derive Support Amounts

Once the Commission has an analytical methodology in place to determine forward-looking costs for each specified geographic area, the next step is to establish the rules for deriving support amounts Western Wireless submits that such rules should meet each of the following criteria:

(1) As directed by the Tenth Circuit, the methodology for all carriers, rural as well as non-rural, must be "sufficient" and must be targeted to advance the statutory goals of "affordable" rates in high-

75/ *Western Wireless Model Ex Parte*, Attachment 2 ("Universal Service The Wireless Solution"), at 19

cost areas that are "reasonably comparable" to those in urban areas. 76/

(2) The methodology must be competitively and technologically neutral Thus, it should not make any difference whether the geographic area is served by a rural ILEC, a non-rural ILEC, a competitive ETC, or some combination.

(3) The methodology should provide sufficient federal support for a carrier seeking to serve a given high-cost geographic area, regardless whether that area is located in a state with average costs that are above or below the national average

(4) The methodology should provide sufficient *federal* support to give states with costs well above the national average the resources to supply any needed intrastate support.

(5) The methodology should include "inducements" for states to take any necessary intrastate actions to eliminate implicit support, as required by the 1996 Act. 77/

There are a number of possible approaches that would satisfy these objectives Qwest Communications outlined one possible approach in its comments

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76/ *Qwest Corp v FCC*, 258 F 3d 1191 (10th Cir 2001) *See also Tenth Circuit Remand Order* ¶¶ 36-48 (clarifying FCC's definitions of key terms)

77/ *Qwest Corp v FCC, supra*

in the Tenth Circuit Remand proceeding 78/ Under Qwest's proposal, the current high-cost support mechanisms (model-based support and Interstate Access Support) would be replaced by what Qwest called "Tier One" and "Tier Two" support. Tier One Support would be based on a simple comparison of the cost of service in each area with a national benchmark (such as the $31 benchmark currently used in determining support for non-rural carriers). Tier Two Support (like the Model-Based Fund today) would be designed to provide funding to the highest-cost states that have the least ability to generate needed intrastate funding based on the divergence between the statewide average cost and the national average, while at the same time ensuring that the most rural areas are eligible for federal universal service funding While Qwest offered its proposal specifically for areas served by non-rural ILECs and their competitors, Western Wireless believes a similar approach could also be applied to areas served by rural ILECs and their competitors The Commission should seek further comment on this idea 79/

78/ Qwest Comments, CC Docket No 96-45 (10th Circuit Remand Proceeding) (filed April 10, 2002) *see also Ex Parte* Letter from John W Kure, Qwest, to Marlene H Dortch, Secretary, CC Docket No 96-45 (filed Oct 1, 2003) (summarizing Qwest's position on the Tenth Circuit remand)

79/ While the Commission did not adopt Qwest's proposal in the *Tenth Circuit Remand Order*, it did not altogether reject it either – the further NPRM mentions the proposal and seeks further comment on related issues *See Tenth Circuit Remand Order FNPRM*, ¶ 130 n.420

Another, similar alternative would be to provide increasing percentages of federal support for geographic locations of increasing cost. For example, the federal fund could provide 25% of the difference between the forward-looking cost and the benchmark average cost for locations with costs that are 135% to 150% of the national average, 50% for locations 150% to 200% of the average, 75% for locations 200% to 250% of the average, and 100% of the difference between the forward-looking cost and the benchmark average cost for locations with costs that are 250% of the national average

C. The Rules Must Include Inducements for Eliminating Implicit Subsidies from Retail Rates

Section 254 forbids the Commission from indefinitely maintaining implicit subsidies in the interstate rate structure, 80/ and at a minimum "states a clear preference" that states take complementary actions to eliminate implicit support from intrastate rates 81/ This is because, as the Commission has long recognized, "implicit subsidies have a disruptive effect on competition;" 82/ "may discourage efficient local and long distance competition in rural areas and limit consumer choice," 83/ and "may undermine efficient competition by permitting an incumbent carrier to price services below cost " 84/ Western Wireless submits that, consistent with the Tenth Circuit's ruling, the universal service high-cost support

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80/ *Texas Office of Public Utility Counsel v FCC*, 183 F 3d 393, 406 (5th Cir 1999), *Alenco*, 201 F 3d at 624, *Texas Office of Public Utility Counsel v FCC*, 265 F 3d 313, 318 (5th Cir 2001)

81/ *Tenth Circuit Remand Order*, ¶ 26, *see also Qwest Corp v FCC*, 258 F 3d at 1203, *AT&T Corp v Iowa Utilities Board*, 525 U S 395, 393-94 (1999) (noting that "§ 254 requires that [intrastate] universal service subsidies be phased out, so whatever possibility of arbitrage remains will be only temporary" in response to ILEC concerns that availability of unbundled network elements at TELRIC would enable entrants to avoid the burden of universal service subsidies built into ILECs' intrastate retail rates)

82/ *Access Charge Reform*, Order on Remand, 18 FCC Rcd 14976, 14977-78, ¶ 2 (2003)

83/ *MAG Order*, 16 FCC Rcd at 6-7, ¶ 6

84/ *Id* , n 193 *See also Access Charge Reform*, First Report and Order, 12 FCC Rcd 15982, 15995-96, ¶ 30 (1997) ("Implicit subsidies also have a disruptive effect on competition, impeding the efficient development of competition in both the local and long-distance markets For example, where rates are significantly above cost, consumers may choose to bypass the incumbent LEC's switched access network, even if the LEC is the most efficient provider Conversely, where rates are subsidized (as in the case of consumers in high-cost areas), rates will be set too low and an otherwise efficient provider would have no incentive to enter the market In either case, the total cost of telecommunications services will not be as low as it would otherwise be in a competitive market Because of the growing importance of the telecommunications industry to the economy as a whole, this inefficient system of access charges retards job creation and economic growth in the nation ")